INDEX

	Page
The Facts	1
Statute Involved	2
Argument:	
Where a taxpayer sells property at a loss, is he entitled to a deduction of a greater sum than the actual loss on the transaction for a "loss sustained" under the provisions of the Revenue Act of 1918?	4
"Loss sustained" means actual loss suffered	4
Only actual losses are allowed to be deducted	7
This Court has held that loss and gain mean actual loss and actual gain	10
The change in the 1921 Act is not a fundamental modification of the law but merely a more detailed statement of its application	15
An examination of the Goodrich case shows that only actual gains and losses are intended	16
The construction given to existing laws by the executive officials charged with their enforcement is entitled to great weight	19
Conclusion	27
Appendix	29

AUTHORITIES CITED

Cases:	
Bush v. *Law et al.*, 201 N. Y. Supp. 513	27
Doyle v. *Mitchell Bros. Co.*, 247 U. S. 179	5, 12, 13
Goodrich v. *Edwards*, 255 U. S. 527	6, 10, 11, 15, 16, 19, 27
Hays v. *Gauley Mountain Coal Co.*, 247 U. S. 189	14
National Bank v. *Whitney*, 103 U. S. 99	27
People ex rel. Keim v. *Wendell*, 193 N. Y. Supp. 143	25
People ex rel. Klauber v. *Wendell*, 188 N. Y. Supp. 301; 232 N. Y. 549	21, 24
Stratton's Independence v. *Howbert*, 231 U. S. 399	14
United States v. *Flannery*, Oct. Term, 1924	4
Walsh v. *Brewster*, 255 U. S. 536	10, 11, 15, 19, 27
Miscellaneous:	
Opinions of Attorney General, vol. 33, p. 291	20
Report of Committee on Ways and Means, by Mr. Fordney, p. 9, 1921 Revenue Act	15
Revenue Act of 1918, 40 Stat., c. 18, p. 1057	2, 3, 4, 7, 8, 10
Treasury Dec. 3206, 23 T. D. 764	20

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In the Supreme Court of the United States

OCTOBER TERM, 1924

BLAKELY D. McCAUGHN, COLLECTOR OF Internal Revenue, petitioner, *v.* CHARLES H. LUDINGTON	No. 733

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR PETITIONER

The case is here on writ of certiorari to review the action of the Circuit Court of Appeals in reversing the judgment of the District Court, which District Court rendered judgment for petitioner on the suit of the respondent brought to recover certain income taxes for the year 1919 paid under protest.

THE FACTS

Prior to March 1, 1913, the respondent purchased shares of stock in certain corporations for $32,500.00. On March 1, 1913, the stock had advanced in price until its market value was $37,-050.00. Respondent held it, however, until 1919,

when it had so depreciated in value that he sold it for $3,866.91.

As a result, the Commissioner of Internal Revenue allowed him as a deduction from gross income for 1919 for "losses sustained during the taxable year and not compensated for by insurance or otherwise," the actual loss sustained, being $28,-633.09, the difference between the cost and the selling price. The respondent claimed, however, the right to deduct as a " loss " $33,183.09, the difference between the market value of March 1, 1913, and the selling price.

The respondent brought suit in the District Court to recover the additional tax of $3,094.00 paid under protest as a result of this difference. The District Court rendered judgment for the defendant. (*Ludington* v. *McCaughn,* 290 Fed. 604.) On appeal, the judgment was reversed by the Circuit Court of Appeals and a new trial directed. (*Ludington* v. *McCaughn,* 1 Fed. (2d Series) 689.)

The question is whether a taxpayer is entitled, under the Revenue Act of 1918, to deduct for a " loss sustained " a larger amount than his actual loss on the transaction. In other words, can the " loss sustained " be more than the actual loss?

STATUTE INVOLVED

The taxes in question were collected under the provisions of the Revenue Act of 1918. (40 Stat., Chap. 18, p. 1057, approved February 24, 1919.)

Sections 210 and 211 of the Act of 1918 levied certain income taxes to be paid annually upon the entire net income received in the preceding calendar year from all sources by every individual a citizen or resident of the United States.

Section 212 (a) provides, regarding income:

> SEC. 212 (a). That in the case of an individual the term "net income" means the gross income as defined in Section 213 less the deductions allowed by Section 214.

And Section 214 enumerates these deductions allowed, and, among others, as follows:

> SEC. 214 (a) That in computing net income there shall be allowed as deductions: * * *
>
> (5) Losses sustained during the taxable year and not compensated for by insurance or otherwise, if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

And Section 202 (a) contains a specific provision concerning the ascertainment of the gain derived or loss sustained from a sale of property, as follows:

> SEC. 202 (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price

or value of such property as of that date; and

(2) In the case of property acquired on or after that date the cost thereof, or the inventory value if the inventory is made in accordance with Section 203.

ARGUMENT

Where a taxpayer sells property at a loss is he entitled to a deduction of a greater sum than the actual loss on the transaction for a "loss sustained" under the provisions of the Revenue Act of 1918?

This question is in principle that recently argued by the Government in the case of *United States* v. *Flannery,* and on the general question as to the true construction of the statute we refer to our brief in that case.

"Loss sustained" means actual loss suffered

The taxpayer contends that as he *might have been able to sell* the stock on March 1, 1913, for $37,050.00, he should deduct his sale price from this figure and call his "loss sustained" $33,183.09.

This contention of the taxpayer is controverted by the direct wording of the statute. The words "loss sustained" in Section 214 of the Act would not seem to need definition. "Loss" is a word which is so simple and certain and well understood in its meaning that it is difficult to define. It suffices to say it is the opposite of gain, a deprivation. The two words "loss" and "gain" are mutually exclusive. The word "sustained" is also simple and well understood.

It means suffered or undergone. Every word in an act is considered as being used to express some definite meaning and purpose. The office of the word " sustained " is clearly to emphasize the use of the word " loss," in the sense of an actual loss suffered, and necessarily excludes the sense of a mere reduced valuation, which would be only a fictitious or paper claim of a loss. It is not possible to read " loss sustained " to mean any larger sum than the taxpayer has been actually deprived of. A tax law is practical and deals with realities and not "might-have-beens."

To constitute a loss, there must be a realization of loss or deprivation of property, by sale of the property for less than it cost. The cost of acquisition and the proceeds of sale are the determining factors of loss and also of gain.

Men who sell property consider that the difference between the selling price and what the property cost one, is what he has gained or lost. Such is the common-sense, practical, ordinary, and exact meaning which this Court has given to the word "loss."

> It can not be said that a conversion of capital assets invariably produces income. *If sold at less than cost, it produces rather loss or outgo.* *Doyle* v. *Mitchell Bros. Co.,* 247 U. S. 179, 185. (Italics ours.)

The same practical definition was given the word " gain," which is the direct converse of " loss," in the *Goodrich* case:

> It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor. *Goodrich* v. *Edwards,* 255 U. S. 527, 535.

A change in market valuation of property, without realization by either acquisition or sale, is a false factor in the computation of gain or loss and has no place therein. Before it could be said that there was a deductible "loss sustained," it must appear, by a comparison of the selling price with the cost of the property, that there was an actual loss. This is the ordinary, well-understood and exact meaning of the word which has been accepted without question and approved by this Court. It is also the practical conception of a practical world. While there are a few speculators and investors, who idly spend their time in counting sadly the "gains" they might have made if they had sold at some earlier time, or in joyful reflections as to the losses they have escaped by not selling, yet the practical man gives little heed to temporary fluctuations in market values which are intermediate between the time he bought and the time he sold. Certainly, a taxing law is not less practical. Both the law and the business world recognize that these quoted market values are often highly conjectural. To offer to sell is too often to find that the market value is fictitious. Is it likely that Congress was blind to this fact?

This definition of the word "loss" in the act is borne out by a consideration of the entire act.

Only actual losses are allowed to be deducted

Taxation is a very practical matter. Indeed, it is the most practical matter known to Government. It concerns itself with the substance of the thing upon which it imposes the tax.

In all the Income Tax Acts certain deductions are allowed the taxpayer from his gross income in order to determine his net income. It is natural and right that the taxpayer should be allowed to deduct the expenses of his business and the losses and depreciation he has suffered. But there is no possible reason why he should be permitted to deduct any conjectural loss, or what is commonly known as a paper loss. His gross income is measured by his actual receipts, and his net income is intended to be his actual gains, profits, or income. So that if he were permitted to deduct paper or conjectural losses the resultant would be less than his real net income.

In Section 212 (a) of the Act, it states:

> That in the case of an individual the term "net income" means the gross income as defined in Section 213, less the deductions allowed by Section 214.

Here we have the statement in the Act of why the deductions are allowed. From the gross income such deductions are allowed as are necessary

to give the taxpayer's net income. This is the definite statement of the purpose and intention of Congress regarding the deductions.

Upon considering the deductions allowed to a taxpayer (Revenue Act, 1918, Sec. 214, clauses (1) to (12)), it is seen they are of three groups:

(a) Moneys paid out in the business.

These include (1) expenses paid, (2) interest paid, (3) taxes paid, (11) contributions to charity.

(b) Losses sustained.

(4) Losses sustained in the business, (5) losses sustained in other transactions entered into for profit, (6) other losses sustained arising from fires, storms, shipwreck, or other casualty, or theft.

(c) Decrease in value of property.

(7) Worthless debts charged off, (8) allowance for exhaustion, wear, tear, and obsolescence of property, (9) amortization of facilities provided for war purposes, (10) depletion of mines, oil and gas wells, and timber, (12) loss resulting from reduction of value of inventory.

In none of these can the deduction be for more than the actual money outlay, or actual money loss suffered by the taxpayer. These deductions are all limited and explained either in the Act itself or in the Regulations which the Commissioner is authorized to make. Thus in all three of the clauses relating to " losses sustained " the

law states the limitation "if not compensated for by insurance or otherwise."

And it is by allowing only actual losses to be deducted that the net income can be correctly arrived at. Congress has sought by the Act to arrive at the true net income of the taxpayer, and to levy the tax on that. Congress has sought to determine the actual net income of the taxpayer. And the deductions allowed are not gratuities. In no case is a deduction allowed which is not necessary in order fairly and justly to arrive at the actual net income of the taxpayer.

So that the whole Act, the exact wording of the statute, and all particulars of the deductions allowed, show that a deduction is allowed only for the actual loss which has been sustained or suffered.

It should be noted that the taxpayer, by his contention, does not say he was charged with a gain he did not have, nor does he say he sustained a loss which he was not permitted to deduct. The net income, as figured by the Commissioner, correctly states his net income. But the respondent seeks to construe one sentence of the act so as to allow him to pay taxes on *less* than his net income. In other words, to give him a gratuity, as compared with other taxpayers, who have sustained no losses but who pay a tax upon their actual net income. And the basis for his contention for this preferential treatment is an unreasonably literal

construction of one sentence of the act divorced from its context. His construction is inconsistent with the other parts of the act and with the whole meaning and purpose of the act. The allowance of this taxpayer's contention would be an injustice to the great mass of taxpayers not similarly situated. The act does not admit of such a construction, and Congress never intended such an inequality in meeting the burdens of taxation.

The Income Tax Act levies the tax upon the net income of all persons and seeks to treat all equally. The construction contended for by respondent sticks in the bark, does violence to the spirit of equality, and is inconsistent with the other parts of the act as well as its meaning and purpose.

This Court has held that loss and gain mean actual loss and actual gain

The Act also provides:

> SEC. 202(a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date.

This Court construed these sections of the law in the 1916 Act, in the cases of *Goodrich* v. *Edwards,* 255 U. S. 527, and *Walsh* v. *Brewster,*

255 U. S. 536. In those cases the question was as to gains, and it was held that by gains was meant actual gains. After discussing the matter, the Court said:

> It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor, and we therefore agree with the Solicitor General that since no gain was realized on this investment by the plaintiff in error no tax should have been assessed against him. [Italics by the Court.]
>
> *Goodrich* v. *Edwards,* 255 U. S. 527, 535.
> *Walsh* v. *Brewster,* 255 U. S. 536.

While the question in those cases was as to the gain derived, it is impossible for one to determine his gains without at the same time determining his losses. Loss is the converse of gain, and the figures which determine if there is a gain, at the same time determine if there is a loss. Losses and gains are the factors which bring about the ultimate result.

It was said by this Court in construing the 1909 Act:

> Understanding the term [income] in this natural and obvious sense, it can not be said that a conversion of capital assets invariably produces income. *If sold at less than cost, it produces rather loss or outgo.*

Doyle v. *Mitchell Bros. Co.,* 247 U. S. 179, 185. [Italics ours.]

The sale of an article for less than cost produces a loss. This definition of loss was before the *Goodrich case.* And the *Goodrich* and *Walsh* decisions as to gains logically follow this statement. In fact, the positive definition of either gain or loss just as positively determines the definition of the other word. In the *Doyle case* it was said that the sale of an article for less than its cost produces loss. In the *Goodrich* and *Walsh cases* it was said that the sale of an article for more than its cost produces gain.

The wording of the Act shows that Congress intended these words " gain derived " and " loss sustained " to be construed as correlative and interdependent. The statute reads: " for the purpose of ascertaining the gain derived or loss sustained." The use of these words in one sentence separated only by the disjunctive " or " shows that Congress intended them to be construed together. They are so closely united in this sentence that not even the word " the " is repeated, but grammatically the word " the " modifies both words " gain " and " loss." So that it is not possible to use these words and show more positively that the same modifying words are intended to apply to one as to the other.

It is not reasonable to argue that Congress by this use of these words intended to say " for the

purpose of ascertaining the (*actual*) gain derived or (*paper* or *fictitious*) loss sustained." Such an interpretation would do violence to the English language. And as this Court held in the *Goodrich* and *Walsh cases* that "gain derived" means actual gain, it necessarily follows that "loss sustained" means actual loss, as it said in the *Doyle case*.

Then, too, the ordinary, common, and unquestioned meaning of the words "gain" and "loss" and their use by Congress in this sentence separated by the disjunctive "or" compel the conclusion that the same transaction can not result in a gain *and* a loss. If there is a gain in the transaction, there can not be a loss; and if there is a loss, there can not be a gain also in the same transaction.

But if respondent's contention were allowed, there would be both a gain and a loss in many transactions.

In *Doyle* v. *Mitchell Bros. Company,* 247 U. S. 179, 183, the Court, after analyzing the provisions of the 1909 Act, said:

> The suggestion that the entire proceeds of the conversion should be still treated as the same capital, changed only in form and containing no element of income although including an increment of value, we reject at once as inconsistent with the general purpose of the Act. Selling for profit is too familiar a business transaction to per-

> mit us to suppose that it was intended to be omitted from consideration in an act for taxing the doing of business in corporate form upon the basis of income received "from all sources."

And after quoting the definition of income from *Stratton's Independence* v. *Howbert*, the Court continued (p. 185):

> Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo.

In the case of *Hays* v. *Gauley Mountain Coal Company*, 247 U. S. 189, which arose under the same Act and was decided on the same day, this Court said (p. 192):

> That the sale resulted in a gain or profit to the exent of $210,000, the difference between the buying and selling prices, is not to be doubted.

These cases show that this Court understood the words gain and loss in the Income Acts in this common sense, ordinary, practical meaning, when there was no question of a constitutional limitation involved. So that the decisions in the *Goodrich* and *Walsh cases* were not a departure, but were the natural and logical continuation of, and conclusion from, the previous statements and expressions of this Court.

After the decisions in *Goodrich* v. *Edwards* and *Walsh* v. *Brewster*, the Revenue Act of 1921 was passed by Congress. In this Act the provision regarding deduction for such a loss was the same. But the provision regarding " the basis for ascertaining the gain derived or loss sustained " was elaborated and made more definite.

The change in the 1921 Act is not a fundamental modification of the law but merely a more detailed statement of its application.

In the Report of the Committee on Ways and Means of the House of Representatives by Mr. Fordney reporting this bill, it is said:

Basis for Determining Gain or Loss

> SECTION 203. In the case of property acquired before March 1, 1913, under existing law, the basis for determining gain or loss is the fair market price or value of such property as of that date. The decision of the Supreme Court in the case of *Merchants Loan & Trust Co.* v. *Smietanka* (decided March 28, 1921) *makes necessary not a fundamental modification of that rule but a more detailed statement of its application.* [Italics ours.]
>
> The proposed bill gives explicit effect to the doctrine approved in that decision; provides that the general basis for ascertaining the gain derived or loss sustained from the sale or other disposition of property shall be the cost of such property;

> but that in the case of property acquired before March 1, 1913, (1) if its fair market price or value as of March 1, 1913, is in excess of the cost, the gain to be included in the gross income shall be the excess of the amount realized therefor over the fair market price or value as of March 1, 1913; (2) if its fair market price or value as of March 1, 1913, is lower than cost, the deductible loss shall be the excess of the fair market price or value as of March 1, 1913, over the amount realized therefor; and (3) if the amount realized therefor is more than cost but less than its fair market price or value as of March 1, 1913, or less than cost but more than such fair market price or value, no gain or loss shall be recognized. (Report of Committee on Ways and Means, by Mr. Fordney, p. 9, 1921 Act.)

So that while the clause in question was stated in more detail, this was considered by Congress *"not a fundamental modification of that rule but a more detailed statement of its application."* The law was not changed, but certain particulars were stated in detail, which before had been left to inference. And, always, in this as in the previous acts, loss and gain are considered correlative and interdependent.

An examination of the Goodrich case shows that only actual gains and losses are intended.

It seems desirable to examine the case of *Goodrich* v. *Edwards, supra,* to see what was the

concession by the Solicitor General in that case, and what was said by this Court. The brief filed by the Solicitor General contains a very clear statement of the facts and the law applicable thereto, and we print it as an appendix.

My distinguished predecessor's brief stated the Government's contention, then and now, very clearly. The interpretation of the law by the Commissioner required the taxation of what were not gains or income, and that interpretation could not be allowed to stand. The Solicitor General, therefore, conceded that the Government was wrong in this contention. The use of the words gain and loss in their common, ordinary, natural meaning made the act as a whole harmonious, gave force and effect to every part, and this construction made the act as a whole constitutional and valid.

This was the view taken by this Court which stated its position as follows:

> As to the second payment. The Government confesses error in the judgment with respect to this assessment. The stock was sold in the year for which the tax was assessed for $22,253.75 less than its value when it was acquired but for $120,710.75 more than its value on March 1, 1913, and the tax was assessed on the latter amount.
>
> The act under which the assessment was made provides that the net income of a "taxable person shall include gains, profits, and income derived from * * *

sales, or dealings in property, whether real or personal, * * * gains or profits and income derived from any source whatever." (39 Stat. 757; 40 Stat. 300, 307.)

Section 2 (c) of this same act provides that "for the purpose of ascertaining the gain derived from a sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived."

And the definition of "income" approved by this court is "'The gain derived from capital, from labor, or from both combined,' provided it be understood to include profit gained through a sale or conversion of capital assets." (*Eisner* v. *Macomber*, 252 U. S. 189, 207.)

It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor, and we therefore agree with the Solicitor General that since no gain was realized on this investment by the plaintiff in error no tax should have been assessed against him.

Section 2 (c) is applicable only where a gain over the original capital investment has been realized after March 1, 1913, from a sale or other disposition of prop-

erty. (*Goodrich* v. *Edwards,* 255 U. S. 527, 534, 535.)

And on the authority of this case on the same day the Court decided the case of *Walsh* v. *Brewster,* 255 U. S. 536.

It will be observed that this Court raised no constitutional question on this phase of these cases and decided them on the very simple reasoning:

> It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that *gains* are derived therefrom by the vendor.

The Circuit Court of Appeals in its opinion in the instant case seemed to think that this Court had been forced to decide some constitutional question in the Goodrich case and was compelled to give a forced and unintended meaning to the act in order to construe it as constitutional.

But it is readily seen that this is not the fact. The difficulty arose because the Commissioner had interpreted the law incorrectly, and the Solicitor General conceded this. This Court did not find it necessary to pass upon any constitutional question, or any canons of interpretation of constitutional questions, for it found the position of the Solicitor General in his concession was the natural and correct construction of the act.

The construction given to existing laws by the executive officials charged with their enforcement is entitled to great weight.

Ever since the decision of this Court in *Goodrich* v. *Edwards* and *Walsh* v. *Brewster*, the administrative department of the Government has construed the word loss as meaning actual loss.

Since that decision, in accordance with the reasoning of this Court, actual losses have been allowed as deductions. Many millions of dollars which had been collected were refunded or allowed as deductions.

Immediately after the decision in the *Goodrich* and *Walsh* cases, the Treasury Department issued Treasury Decision 3206, which reads, in part, as follows (23 T. D. 764):

> Regulations 45 (1920 Edition) are hereby amended in order that the rule announced by the Supreme Court in the cases of *Goodrich* v. *Edwards* and *Brewster* v. *Walsh*, respecting the basis for the determination of taxable gain or deductible loss in the case of property acquired prior to March 1, 1913, and sold or disposed of subsequent thereto, may be incorporated therein. * * *

The Attorney General also gave his opinion that this was the law and the correct construction of the law as interpreted by this Court in the *Goodrich* and *Walsh* cases. (33 Opp. Atty. Genl. 291.)

That has been the construction given to the law for nearly four years now, and that construction should not be set aside unless the law compels it.

It is difficult to estimate the number of cases which would be overturned by a change in the construction at this time. They would need to be reopened, refunds allowed, and everything recomputed on a new basis. The amount involved in the case at bar is not large, but it is estimated that the amount involved to the Government in the decision of his question amounts to many million dollars. Now to set aside these accepted rulings means uncertainty, confusion, and loss. Only when the law imperatively compels it should the Court require it.

The State of New York has an Income Tax Law, in which the wording of these sections of the Act of 1918 is followed except that January 1, 1919, is used instead of March 1, 1913. In the case of *People ex rel. Klauber* v. *Wendell* (196 App. Div. 827; 188 N. Y. Supp. 301) the Supreme Court considered a case exactly like the *Goodrich* and *Walsh* cases, and came independently to the same conclusion that this Court announced in the *Goodrich* and *Walsh* cases. The Court says:

> Section 353 [corresponding to Section 202 (a) of the Federal Act] speaks of the "gain derived" from the sale of property, and that clearly means such "gain" as is described and referred to in Section 359 [corresponding to Section 213 of the Federal Act]. And Section 353 then provides that, for the purpose of ascertaining such gain, the basis shall be, in case of property acquired before 1919 [corresponding to March 1, 1913, of the Federal Act], the

market value thereof on January 1st of that year. The two sections read together to my mind clearly indicate that there must first be a gain, as indicated in Section 359, as between the purchase price and selling price, and then, in cases where there is such a gain, the portion thereof subject to taxation shall be ascertained by deducting the market value of the property on January 1, 1919, from its selling price. The Legislature did not intend to treat that as a gain which was an actual loss, simply because there was an appreciation in value after January 1, 1919, but in cases where there was an actual gain in the selling price over the cost price to include as gross income only that portion of such gain as accrued after January 1, 1919. That was the year when the Income Tax Law became effective, and the legislative purpose clearly was not to tax any gains or profits which might have accrued before that year, but to include in gross incomes only that portion of the gains or profits which accrued during the taxable period in cases where such gains or profits had actually been derived.

* * * * *

The manifest purpose of the Congress, therefore, as it seems to me, was to exclude all gains or profits which accrued prior to the constitutional amendment, and which were realized by sales or transactions thereafter, making only such portion of such gains or profits as accrued after the amendment subject to the tax. The purpose

was not to make an appreciation in the value of property subsequent to the amendment the subject of taxation, irrespective of whether or not the entire transaction involved a gain or loss. Of course the state Legislature is not fettered by constitutional restrictions, as was the Congress; but, having adopted the act of Congress substantially in haec verba, it is reasonable to assume that the purpose of the two enactments was the same, although the motive and necessity for such purpose did not exist in respect to the state enactment. I conclude that full effect and meaning may be given to section 353 of the Tax Law by applying it only to those cases where a sale or other transaction results in an actual gain or profit and the history and origin of the statute, as well as a reasonable construction thereof, and a due regard both to the equities of the taxpayers and justice to the state all combine to indicate that such was the legislative purpose.

Since writing the foregoing opinion the United States Supreme Court in the cases of *Goodrich* v. *Edwards* (255 U. S. 527) and *Walsh* v. *Brewster* (255 U. S. 536) has, without reference to constitutional requirements, construed the federal statute as the state statute is here construed. (*People ex rel. Klauber* v. *Wednell,* 196 App. Div. 827; 188 N. Y. Supp. 301, 302–304.)

And this was affirmed by the Court of Appeals of New York. (*People ex rel. Klauber* v. *Wendell,* 232 N. Y. 549; 134 N. E. 567.)

Later there came before that court the same question as is before this Court in the case at bar, on the question of the amount of the loss which could be deducted when two short-sale transactions were entered into before 1919 and closed out at a loss during 1919. The Court said:

> The two short-sale transactions were entered into for profit, and loss was incurred in each transaction, part of which was sustained during the taxable year. Under the statute and the decision in the *Klauber case* to justify a deduction there must be a loss on the transaction; but the deduction allowed can not be greater than the actual loss incurred on the whole transaction nor than the loss "sustained during the taxable year"—that is, after January 1, 1919. In order to determine the actual loss the price at which the stocks were sold short must be compared with the price at which they were bought in when he covered. To ascertain the loss in 1919 the market value of the securities on January 1, 1919, must be compared with the price when the stocks were bought in.
>
> * * * * *
>
> This construction as here given the statute finds support in decisions of the Supreme Court of the United States *Goodrich* v. *Edwards,* 255 U. S. 527;

Walsh v. *Brewster,* 255 U. S. 536; *Merchants' L. & T. Co.* v. *Smietanka,* 255 U. S. 509), in which the Federal Income Tax Law, containing provisions in all essentials similar to our state Income Tax Act of 1916, as amended in 1917, known as the Revenue Acts of 1916 and 1917 (39 Stat. 756, c. 463, as amended by 40 Stat. 300, c. 63), except that the initial date is March 1, 1913, is construed. In those cases the court recognizes that gains or losses which accrued before March 1, 1913, were excluded in calculating the net income, and the fair market value on March 1, 1913, of the property dealt in, is the basis for determining the gain or loss.

The comptroller has made the proper allowances, excepting as to the second item the loss can not be greater than the actual loss, and should therefore be $13,407.50, rather than as allowed, $15,702.50. (*People ex rel. Keim* v. *Wendell,* 200 App. Div. 388; 193 N. Y. Supp. 143, 148, 149.)

It will be noted that that court after citing the decisions of this Court, says, *supra*:

> In those cases the court recognizes that gains or *losses,* which accrued before March 1, 1913, were excluded in calculating the net income, and the fair market value on March 1, 1913, of the property dealt in, is the basis for determining the gain or loss. (Italics ours.)

In other words, the Supreme Court of the State of New York construes the decisions of this Court the same way they have been construed by the Solicitor General, the Attorney General, the Treasury Department, and the Commissioner of Internal Revenue of the United States, as settling the rule for both gains *and* losses.

Later another case came before that court involving losses, and was decided the same way.

Property purchased by the taxpayer had increased in value a certain amount until January 1, 1919 (the date under the New York Act corresponding to the date of March 1, 1913, under the Federal law). This property was sold in 1919 for a much smaller sum but still at a profit to the taxpayer over the cost. The State Tax Commission assessed an income tax on the profit derived and refused to allow a deduction for the alleged loss for the sale at less than the value of January 1, 1919. This determination of the State Tax Commission was confirmed by the Supreme Court, the law evidently being considered settled in New York, with regard to both gains and losses in correspondence with the decisions of this Court, and partly, at least, in reliance thereon. The opinion of the Supreme Court is brief:

> Per curiam: Determination confirmed, with $50 costs and disbursements, upon the authority of *People ex rel. Klauber* v. *Wendell* (196 App. Div. 827; 188 N. Y.

Supp. 301; affirmed 232 N. Y. 549; 134 N. E. 567; and *People ex rel. Keim* v. *Wendell,* 220 App. Div. 388; 193 N. Y. Supp. 143). (*Bush* v. *Law et al., State Tax Commission,* 206 App. Div. 800; 201 N. Y. Supp. 513.)

CONCLUSION

It was said by this Court that:

> Judicial decisions affecting the business interests of the country should not be disturbed except for most cogent reasons. *National Bank* v. *Whitney,* 103 U. S. 99, 102.

That is very applicable to this case. While the *Goodrich* and *Walsh cases* were concerned with gains, they necessarily determined the rule for losses. The reasoning of the Court in those cases required the rule which has been followed by the Government in all the cases arising since that time. A change in that rule now would mean great disturbance as well as injustice and unfairness to the great mass of taxpayers of the country.

It is submitted that a decision in favor of the respondent would require a technical construction of one sentence of the act, and be contrary to every other part of the act, would be contrary to the intention of Congress as expressed in the act, would be contrary to the reasoning of the decisions of this Court, would be an unfair preference

to the respondent, and, therefore, unfair and unjust to the other taxpayers.

Respectfully submitted.

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Solicitor General.

Robert P. Reeder,
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Of Counsel.

January, 1925.

APPENDIX

Extract from brief of former Solicitor General Frierson for defendant in error in *Goodrich* v. *Edwards*, pp. 58–65:

> The application of the law to the two transactions involved in this case.
>
> So far as plaintiff in error seeks to recover the taxes paid on account of the United Verde Extension Mining Company stock transaction there is no difficulty. He purchased the shares in 1912 for $500 and sold them in 1916 for $13,931.22, making a clear gain on the transaction of $13,431.22. It appears, however, that the stock from the time he bought it increased in value, so that on March 1, 1913, it was worth $695. The Commissioner of Internal Revenue, correctly construing the law to entitle him to withdraw as capital from the proceeds of sale the value of his stock on March 1, 1913, deducted $695 instead of the original purchase price and collected the tax on the remainder, or $13,236.22. For the reasons above stated, plaintiff in error was plainly liable for the tax so collected.

With respect to the B. F. Goodrich stock, the situation is different. Plaintiff in error acquired this stock in 1912. It was acquired in a transaction in which he received this stock and a certain amount of cash in exchange for other stocks, which he had previously acquired by gift and bequest. He thus received 3,600 shares, which were worth $81 per share, or $291,600. He sold them in 1916 for $269,346.25, making a net loss on the entire transaction of $22,253.75. But it appears that after he acquired these shares their market value very rapidly declined until on March 1, 1913, the stock of the company sold on the New York Stock Exchange at something in excess of $41 per share. On this basis the Commissioner of Internal Revenue determined that the total value on March 1, 1913, of plaintiff in error's 3,600 shares was $148,635.50. Holding that this was the capital value which was entitled to be withdrawn, as capital from the proceeds of sale, he deducted that amount from the selling price of $269,346.25 and collected taxes on the balance, or $120,710.75. It will be seen that on the entire transaction there was no gain, but, on the contrary, a loss of more than $22,000. The question is whether in such a case any taxable income was received. The theory of the commissioner was that the act of Congress capitalized the assets of a taxpayer at their value as it existed on March 1, 1913. In other words, he ruled that the value, as of that date, must always

control, and that in all cases the difference between this value and a higher selling price is income received when the sale is made.

If this construction of the law is correct a serious constitutional question arises. Whatever gains are made by selling property resulted from three acts—acquisition, holding, and selling. These three acts together resulted in a gain or a loss, according as the selling price is more or less than the acquisition price. It is said, therefore, that unless the entire transaction composed of the three acts mentioned results in a gain there is, in fact, no income. It is true that between the date of acquisition and the date of sale the market price of the property may have fluctuated, so that there may have been times when a sale could have been made at a profit; but if the owner did not choose to sell and take his profit, no income, in fact, resulted from his mere ability to have done so. On the other hand, there may have been times when, if the owner had sold, his loss would have been greater than it was at a later date when he actually sold. But it is said that he was not required to sell when the price was at its lowest and take his loss, and that if he did not do so the question as to whether he finally made a profit or suffered a loss must be determined by comparing the purchasing and selling prices. In other words, the contention is that, under the commissioner's construction of the law, something is taxed

which is not, in fact, income and which Congress was therefore without the power to tax except by apportionment.

After a careful study of the statute the Solicitor General is forced to the conclusion that the commissioner has erroneously construed the statute. It clearly imposes the tax only on *gains* that are derived from the sale of property. It can not be said that there has been a gain resulting from a sale of property at less than it cost, no matter how long an interval may have intervened between the purchase and the sale. The error consists in giving too broad a scope to the rule laid down by the statute for determining the amount of taxable gain derived from sales made during a particular year. From the beginning the income tax acts had imposed a tax only upon gains derived from sale. As shown above, there had been much discussion and difference of opinion as to whether all such gains should be taxed in the year in which received. It was contended that it would be unjust to tax all of such gains when they had resulted from a gradual increase in values during a long period of years. Following the act of 1867, it was at first thought that such gains should be taxed only when the transaction from which they resulted both began and ended in the tax year, or, at least, when the property had been purchased only a short time before the beginning of that year. There was also a doubt of the power of Congress to

tax that portion of such gains which would be represented by the increase in value which had occurred prior to the adoption of the sixteenth amendment.

After much discussion Congress determined that it would not confine the tax to gains made in transactions beginning and ending in the particular year or within any fixed and arbitrary time before that year but that it would simply exclude so much of the gains as could be said to have resulted from increases in value prior to March 1, 1913, practically the date of the adoption of the sixteenth amendment. There had also been a difference of opinion as to how, in such cases, the gains should be apportioned between taxed and nontaxed gains. Under the act of 1909 the Internal Revenue Department had adopted a prorating method, according to the number of years the property was held before and after the effective date of the act. Congress apparently regarded this method unsatisfactory, and instead concluded that the better plan was to ascertain the amount of gains resulting from increase in value before March 1, 1913, by comparing the value on that date with the original cost price. When, therefore, it adopted the provision, which will be quoted below, it was dealing with the question as to how ascertained gains should be divided for the purpose of taxation under this act, or for ascertaining the income which Congress intended should

be taxed in a particular year. For this purpose it used the following language:

"For the purpose of ascertaining the gain derived from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such gain derived." (39 Stat., c. 463, sec. 2 (c), p. 758.)

It seems difficult to escape the conclusion that this provision can have no application until it is first ascertained, by comparing the purchase and selling prices, that there has been an actual gain. When this has been ascertained, the value of the property on March 1, 1913, is to be taken as including that portion of the increase in value finally realized by a sale which occurred subsequent to that date. But when the selling price is less than the purchase price, there has been a loss instead of a gain, and hence there is nothing to which the value on March 1, 1913, can be applied.

Under a proper construction of the act, therefore, it must be conceded that the plaintiff in error was not liable for a tax on account of his transaction in the B. F. Goodrich Company stock.

Having made this concession, however, it is proper to make clear the Government's view with respect to a similar and related

matter. As shown above, losses sustained in business or trade or in transactions entered into for profit are, under certain conditions, permitted to be deducted. Where these losses are allowed and have resulted from the sale of property purchased before March 1, 1913, Congress has made provision for ascertaining the amounts of such losses that may be deducted in much the same language used in providing for ascertaining the amount of income from such sources to be taxed in a particular year. The provision is as follows:

"*Provided,* That for the purpose of ascertaining the loss sustained from the sale or other disposition of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such loss sustained." (39 Stat., c. 463, p. 759.)

This provision, therefore, must be construed as it has been conceded the similar provision relating to income is to be construed—that is, it must first be ascertained by comparing the purchase and selling prices that a loss on the entire transaction has been sustained. When this fact is ascertained we look to the value of the property on March 1, 1913, to determine how much of the loss resulted from a decrease in value prior to that time. Thus.

if property was bought in 1910 for $2,000 and sold in 1916 for $1,000, there was a loss of $1,000. Since all gains, under similar circumstances, are not taxed as income, there was a similar purpose not to allow all such losses. Therefore, if it appeared that on March 1, 1913, the value of the property had decreased until it was worth only $1,500, $500 of the entire loss would be regarded as having resulted from decrease in value occuring before that date, and hence only the remaining $500 of the loss would be allowed as a deduction. On the other hand, if the value of this property had increased until it was worth $2,500 on March 1, 1913, and had then decreased in value until it was finally sold for $1,000, the actual loss would still be $1,000; but the fact that all of this decrease had occurred since March 1, 1913, would be established by the advanced value as of that date, and hence the entire $1,000 would be deductible, and the taxpayer would not be entitled to deduct the difference between the full market value on March 1, 1913, and the selling price. Again, if it appeared that the value had decreased until on March 1, 1913, the property was worth only $1,000 and was later sold for $1,000, there would still be a loss of $1,000; but no deduction would be allowed because the market value of $1,000 on March 1, 1913, would establish the fact that the entire loss had resulted from a decrease in value occurring before that date.

In the present case, if it could be said that in any event the plaintiff in error could deduct from the income derived from one transaction the losses suffered through the other he would not be entitled to a deduction. The reason is that while he suffered a loss on the entire transaction, the value of the stocks had so greatly decreased before March 1, 1913, that if he had sold then his loss would have been very much greater. He did not choose to take his loss at that time, but held the stock for a higher price, which he finally obtained. In other words, the entire decrease in value which resulted in his final loss occurred prior to March 1, 1913. There was thereafter no decrease in value which resulted in a loss, but, on the contrary, an increase in price which overcame, in part, the previous decrease, and there was no loss occurring under the terms of the act after March 1, 1913, which can be deducted.

From what has been said, it results:

1. The taxes paid on the gain derived from the sale of the mining company stock were properly collected.

2. There was no gain resulting from the sale of the B. F. Goodrich Company stock, and the taxes collected on account of that transaction were improperly collected.

3. The plaintiff in error is not entitled to any deduction from the income derived from the first transaction on account of losses sustained in the second.

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